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日本政治経済のフラット化の新興：日本の海外直接投資要因

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Japan's Emerging Flatter Political Economy : The Foreign Direct Investment Factor

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Abstract

Foreign direct investment (FDI) flows into Japan were low from the end of World War II until the end of the Cold War but have increased steadily from the bubble period in the late 1980s and more dramatically from the start of Big Bang reforms in the late 1990s. This paper argues that higher levels of FDI have contributed to transforming Japan' s political economy into one that is "flatter" and significantly more globalized.

Key Words

Foreign, Investment, Japan

Introduction

Since the end of the Cold War, international financial transactions have increased dramatically while foreign direct investment (FDI) has also crossed borders at elevated levels due in part to the diffusion of IT and a trend toward convergence among the world' s largest economies. During this 15 year period, India and China have continued to liberalize trade and further establish property rights while attracting billions of dollars in FDI. Hundreds of millions in both giants have been lifted out of poverty, thereby steadily propelling the trend of the global convergence of wealth.[1] In addition, FDI from the West has greatly increased in Asia from the mid-1990s, creating a new environment in which China's eroding State Owned Enterprises and Japan's weakening *keiretsu* companies must operate. This paper focuses on the impact of FDI on Japan's political economy as the Japanese government enacted the "Big bang" deregulation package in late 1996 and dismantled several areas of regulation while investment flowed in.

The increasing presence of both European and American (and recently Chinese) companies in Japan serve as agents of change. Foreign investment not only affects specific industries through competition and by introducing new operational technology, but also affects the way Japanese industries undergo Schumpeterian "creative destruction" through domestic mergers and acquisitions and thereby influences the way in which Japanese companies interact within and across industries.

Thus, Japan's 'regulatory regime' has been converging over time towards practices found in the U.S. and increasingly in Europe partly due to domestic pressures but also as a result of recent foreign entrants. This trend has accelerated over the past ten years, although several argue that the reforms of the past decade have not been significant and that FDI remained at levels too low to affect change in the political economy. For example, former economic advisor to Ambassador Walter Mondale, Edward Lincoln, downplayed the Big Bang reform in the spring of 2000 declaring that very little change had occurred in Japan except for some signs of financial reform.[2] In 2003, Lincoln wrote specifically about more recent FDI into Japan :

> ...the ratio of FDI to GDP in Japan (is) at 1.1 percent. This compares badly to an average of 30 percent for EU countries, 12 percent for the U.S., and 14 percent even for Korea (a nation that long had strict investment controls). In fact, glancing over the list of all countries, one is hard pressed to find a country with a ratio as low as Japan's. Therefore, despite the flashy appearance of deals like Renault acquiring a minority position in Nissan and installing Mr. Ghosn, the reality is that Japan has very, very little foreign-controlled investment within its borders.[3]

Yet as this paper will show, key foreign investment from foreigners in recent years, regardless of overall stock, is having a positive influence on the political economy of Japan.

More recently, Chalmers Johnson stated after most of the Big Bang laws were enacted through the Diet that there was no evidence of a decline in state led development in Japan, rather, "it is becoming stronger." [4] Berkeley comparativist T.J. Pempel has noted the decline in the amount of cross-holding shares among Japanese *keiretsu* firms during the Big Bang period, yet he has also recently argued that the new deregulation laws and greater inflows have had little impact on inward flows of FDI as of 2004 :

> Japan has been among the industrialized world's most mercantilist countries and one that has deeply resisted moves away from mercantilism. Its level of incoming foreign direct investment per capita, for example, is minuscule to that of the U.S., UK, Germany or France. There are hints of change...but the country retains far more mercantilist, than anti-mercantilist policy makers." [5]

Yet in 2002, the level of Japan : U.S. inward FDI had risen to greater than a 1 : 2 ratio for the first time (in part because U.S. levels dropped during its recession), where the historical ratio had remained closer to a lopsided 1 : 20 during the 1980s. Accordingly, this paper argues that the process of globalization has started to transform Japan's political economy from a system which gradually opened from the 1960s but remained a somewhat closed system due to regulation and an industrial structure dominated by large companies, a powerful bureaucracy and the LDP into one that is more open and flexible, following the passage of Big Bang reforms at the turn of the century. A combination of post bubble period demographic change, some early American *gaiatsu*, reforms initiated in the late 1980s, culminating with a more competitive Diet passing Big Bang laws between 1997 and 2001, provided the impetus for this most recent phase of opening. In 2006, Japan's economic structure is both shifting closer to that of the U.S. and U.K. in several areas and is also reverting to a more liberal financial period which burgeoned during the Taisho period before World War II.

As regulations loosened in the 1990s, Western companies began to enter Japan with modest investments or by expanding previously held shares, largely in manufacturing industries. While the Big Bang laws were passing through the Diet, many foreign firms which were unable to enter the financial sectors, entered Japan to position themselves for a post-Big Bang environment in which accounting practices were more transparent and companies operated more independently from a declining *keiretsu* system. In contrast to many foreign firms that entered and failed to establish a presence in Japan during the 1980s, most of these firms are enjoying early success and along with Japanese joint ventures are influencing all industries.

Renowned economist Michio Morishima concurred that Japan's economy is transforming toward an Anglo-American model and laments the shift as the end of Japan as a dynamic force.[6] In contrast, this paper will conclude that this pessimism is misplaced, and that Japan's emerging economy will continue to be vibrant, and supported by a competitive political system. As a result, the Japanese people will enjoy more choices at a higher standard of living.

Theoretical Considerations of FDI

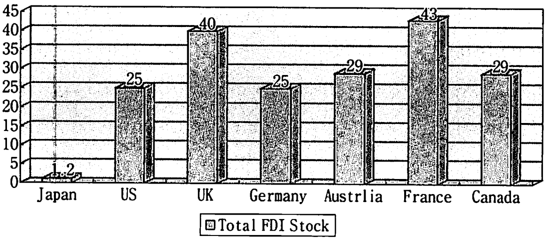
Foreign direct investment may be theoretically conceptualized as a form of international trade.[7] Two fundamental types of FDI, vertical and horizontal, flow from capital intensive nations both to other OECD nations and to developing nations like China. When a multinational invests 'vertically,' cross-country comparative advantage is considered and the plant in the foreign country specializes in one or two stages of production. In this case, trade and FDI are complements, as imported raw materials and components are usually processed for exports. If a multinational invests "horizontally," the firm attempts to access foreign markets. In this case, exporting or investing abroad are substitutes. Multinationals choose one or the other based on relative returns including the cost of FDI and economy of scale potential in a foreign plant.[8] FDI into Japan from the West usually arrives in the form of horizontal investment. Early FDI into Japan tended to accumulate in manufacturing, but FDI from the Big Bang reform period has recently flowed disproportionately into the financial sector and other service industries where Japan has lagged.

FDI benefits a developed country like Japan or the U.S. in ways similar to how a country benefits from receiving imports. First, as Joel Mokyr notes, countries can fall into a stagnant equilibrium where institutions partially beholden to special interests resist importing new technology.[9] A combination of external pressures on institutions with willing foreign investment can provide the catalyst to enhance industries. Second, Oliver E. Williamson explains the results of his empirical research that "overall composition of investment and contracting will reflect changes of both investment and organizational kinds." [10] Foreign direct investment is an important type of this change which is altering both industries and the broader overlapping *keiretsu* structure through introducing technology and competition.

Third, in the specific case of Japan, Hirotaka Takeuchi shows that the rate of technological diffusion is rapid among Japanese firms.[11] One would expect a similar rapid dissemination of new innovation imported from abroad. Fourth, the innovation imported via FDI not only diffuses within an industry but has the potential to spillover across other industries as well. Other companies within an industry tend to mimic successful practices to become more competitive and therefore productive. In addition, as with imported goods, imported investment indirectly expands consumer choice and lowers prices through enhanced competition. Unlike portfolio investment, direct investment requires a much greater commitment by companies staying within the host country for a long period, thereby affecting industry wide practices over time.

Japan received very little FDI through the 1980s for various reasons including a controlled currency until the 1960s, a banking system which provided an unusually large amount of capital in an economy with underdeveloped equity and bond markets, *keiretsu* groups which could quickly join together to help a company block foreign investment, and various regulations including burdensome notification laws through the 1980s.

Graph 1 : Total Stock of FDI



(source : UNCTD 2003)

A Brief History of Foreign Direct Investment into Japan

Foreign direct investment first trickled into Japan shortly after Commodore Perry's black ships forced open trade with Japan in the 1850s and would have an important impact on Japan's rapidly industrializing economy before being shut off as militarists began to take control of the economy in the 1930s. In early Meiji, a type of shadow foreign direct investment entered Japan during Meiji through company advisors in addition to small amounts through port cities at the time Yukichi Fukazawa, a representative of the dichotomy between traditional and new methods, who promoted the modernization of Japan as a nationalist who advocated importing useful knowledge from the West in order to strengthen Japan.[12] Major companies like Standard Oil opened an office in 1893 bringing in energy technology, and "by 1900 was the most heavily capitalized oil firm in Japan." [13] Foreign direct investment eventually reached $50 million by 1913 and had doubled to over $100 million as Japanese companies entered heavier industries.[14]

As Japan continued to rapidly industrialize, the presence of early FDI likely gave productivity a boost before a militaristic government expelled foreigners and took control of parts of a more consolidated *zaibatsu* in the 1930s. By the early 1930s, in addition to Stand Oil, major Western companies including Armstrong Vickers and Siemens-Schucketwerke had flourished in the more developed and open economy with some control in the top 50 largest Japanese firms.[15] General Motors and Ford also built autos in Japan before all foreign companies were expelled as the government took command of production in many industries.[16]

Before the economy reverted to a *sakoku* state, stock shares dominated corporate financing.[17] But cartels strengthened in the early 1920s and were legalized in 1925, but regulations during the 1930s shifted power to banks, as the government began to stress stability after a financial panic in 1927.[18]

In the post-war period, early financing restrictions eased, but powerful institutional guidance through the Ministry of Finance and MITI thwarted the flow of most FDI into the country. This era would prove to be the height of the "iron triangle" of power connecting a strong, conservative Liberal Democratic Party, the bureaucracy and large trust banks (or in some cases, other lobbies including the construction lobby). The strength of this iron triangle diminished through both the bubble period and following the passage of the Big Bang deregulation laws.

The *keirestu* structure strengthened at the onset of the "reverse course" period as the provisional government (SCAP) introduced draconian anti-inflationary measures and enacted policies which allowed a *keiretsu* structure to arise from the pre war *zaibatsu* system. Both the 1949 Foreign Exchange Control Law and 1950 Foreign Investment Law erected walls preventing most FDI from flowing into post-war Japan. Dennis Encarnation and Mark Mason contrast the highly restrictive foreign investment climate in post-war Japan and with that of the pre-war period where foreign investors were exempted from vague exclusionary guidelines "who sought to resume their earlier operations (strictly defined) and who did not seek foreign exchange for their repatriation of yen-dominated profits or the payment of various foreign fees."[19] The post-war laws gave MITI extensive control over which industries would receive foreign exchange and which would not, effectively serving as a gatekeeper of imports that overrode any legislative attempts to lower tariff barriers.[20] The other powerful financial institution, the Ministry of Finance (MoF), essentially "transferred the savings of household depositors at less than competitive rates of interest to Japan's rapidly growing finance-scarce industrial sector. Bank finance replaced the direct financing that had predominated the20th century." [21] This served as a piece of a post-was system which helped exclude FDI until the 1990s.

The Keiretsu Impact

Easy financing from banks strengthened many member firms until after the bubble period when large debt was exposed and not reduced for over a decade. Economic historians point to a scarcity in funds in the Japanese economy that encouraged a *keiretsu* system to emerge around an unusually influential banking system in a political environment which supported the Yoshida Doctrine.[22] After twenty years of stringent controls over inward investment, the government began official liberalization of FDI in 1967, which was largely completed in 1973 ; however, partly due to regulation and incentives to finance within the *keiretsu* system, further erosion of barriers to notable levels of foreign investment would have to wait another quarter of a century.

Political economists differ somewhat with respect when defining a *keiretsu*. However, *keiretsu* are generally understood to take one of three forms : A vertical *keiretsu* consists of a major company which traditionally looked to MITI and MoF for guidance while smaller suppliers connect in a hierarchy with scores of small companies at the bottom rung. Toyota is an example of such a company with an extensive *keiretsu* supplier formation in the auto industry. A horizontal *keiretsu* is a conglomerate of companies centered around a major bank and a trust bank. In addition, the companies invest in each other's companies and will often utilize overlapping board of directors and receive favorable funding from banks.[23] Sumitomo, Mitsui, Mitsubishi, Sanwa, Fuyo and Daiichi Kango have been idendified as major horizontal *keiretsu* groups where the first three have roots to zaibatsu corporations. The third form is referred to as a distribution *keiretsu*, which has eroded due to foreign firms including the arrival of the distribution innovator, Wal-mart. Other common characteristics of the *keiretsu* include : 1) a use of common technology and plants 2) a potential to "compensate for imperfections in capital and labor markets" 3) a practice of "seek (ing) favorable treatments from government." [24]

This paper will show that the new wave of FDI has contributed to the weakening of the *keiretsu* structure which will in turn lower structural barriers for further FDI. This weakening allows greater liquidity in the financial sector as well as structural flexibility as domestic and foreign firms face fewer barriers to necessary mergers and acquisitions. Even one time bureaucratic linchpin MITI has recently stated as a restructured METI that the demise of the *keiretsu* is a goal which can be hastened by further foreign investment in the new post-big bang economy.[25]

Economist Michio Morishima has highlighted the positive aspect of this structure and has argued that the works to "smooth over conflict." [26] Yet several studies show that these same features likely placed some drag on the economy : A mid-1970s study showed *keiretsu* groups earned 1.5% lower returns in the 1960s than independent companies.[27] Another study conducted in the 1980s confirmed this trend in the 1970s showing that *keiretsu* profits were lower than non-*keiretsu* group profits.[28] And a paper in the early 1990s economist Robert Lawrence shows a statistically significant degree of inefficiency in the cross-holding system itself.[29]

As previously stated, one important aspect of the *keiretsu* structure with respect to ease FDI inflow is cross-shareholding whereby companies in this period could easily prevent takeover bids from either domestic firms or foreign rivals as other companies in the group as well as the main *keiretsu* bank hold what collectively adds up to insurmountable controlling interest.

Even small amounts of shareholder activism, at times necessary to vitalize inefficient or otherwise stagnant companies, would be blocked by groups of intimidators known as *sokaiya*, who would guarantee companies that shareholder meetings would be void of any unwelcome announcements or disturbances in exchange for a "handling fee." Companies would in turn try to minimize the effectiveness of *sokaiya* by holding shareholder meetings on the same day, thereby diminishing the already weak power of the shareholders.[30] Liberalization in the 1990s and subsequent influence from the presence of foreign companies would eventually give smaller yet still notable shareholders greater influence within companies, thereby creating a more level and international playing field

The role of banks in corporate financing remained strong for decades, but declined in the 1990s along with once powerful guiding institutions, MITI and MoF. The banks central power declined in part because of a moral hazard problem--a phenomenon summarized in this context as lending because of industrial/banking structural considerations rather than to maximize arm's length return on loans. This has affected banking systems in other OECD states including Australia and Sweden in the 1990s, but was more extensive in Japan. U.S. Federal Reserve Chairman Ben Bernanke outlined the similarities between the U.S. savings and loans problem of the late 1980s with Japan's more recent banking quagmire and concludes while similarities outweigh differences, the enormity of Japan's debt problems, roughly ten times that of the situation in the U.S., sets Japan's banking industry problems in a different league.[31] Because the banks were at the heart of so many large companies and held influence within each one, a negative feedback loop occurred where the banks would lend indiscriminately to companies whose projects failed, thereby building up debt. In turn, these failures began to accumulate across several industries placing a drag on the stock market in which banks had invested much more heavily than banks of other OECD countries. Big-Bang transparency laws and the advent of foreign entrants like Ripplewood Holdings, which made history in Japan by buying a failed bank outright, exposed long festering problems and induced the needed competition to help repair an industry that had been teetering on an outright crisis.

FDI into Japan During the Keiretsu Era

During the post war period of very low FDI inflows into Japan, large multinationals with world wide name recognition including McDonalds, Coca Cola, and IBM entered the Japanese market through special licensing agreements, which kept the parent company influence in Japan low, especially compared with the more recent mergers and acquisitions of the post-Big Bang era. Scott Callon has documented IBM's attempt to become the first foreign producer of computers after successfully reclaiming some pre-war rights, although negotiations with MITI dragged on for years during a period of greater economic insulation.[32]

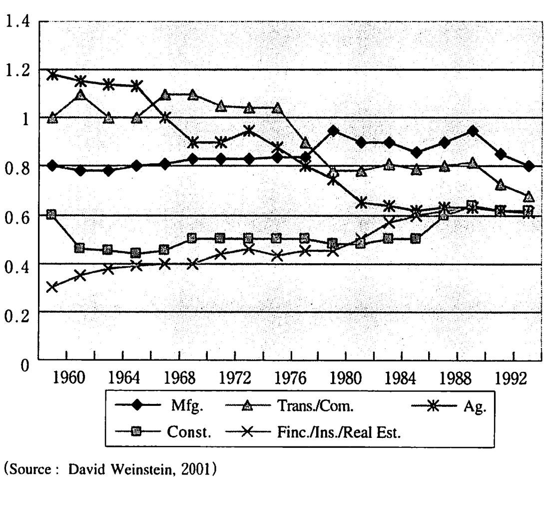
While the Japanese government took steps to lower FDI barriers in the 1960s, 1970s and later 1980s through SII talks, foreign pressure, or "*gaiatsu*" sometimes served as a tool by both U.S. and Japanese companies to open closed sectors prior to the big-bang in the lat 1990s. However, the role of *gaiatsu* during the decades when FDI inflows were almost non-existent should be seen as a lever rather than a hammer. For example, Leonard Shoppa notes that the land use reforms discussed in the context of SII in the late 1980s were already underway in Japan, propelled in part by a demographic shift whereby the younger generation was more inclined to move to a major city rather than take over a small family business.[33] Shigeko Fukai, who has studied the impact of SII talks on land policy concluded in an interview with Shoppa that, "Americans gave just enough added credence to some of their [reformers] ideas to get them enacted." [34] The Big-Bang facilitated a shift from *gaiatsu* away from the U.S. government to foreign companies with interests which meshed those of many foreign firms into a hybrid of *gaiatsu* and "*naiatsu*" which will be apparent in subsequent sections.

FDI after the Bubble : 1990—1996

The period between the "bubble and the Big-Bang" marked the beginning of a new transitional period for Japan as the economy entered into a low growth period (before sliding into an outright recession), the LDP splintered, bureaucratic power waned, and FDI began to flow into industries at increasingly elevated but still low levels over time. During these seven years, some deregulatory reforms allowed in more foreign investment to gain a foothold in several weaker Japanese industries and paved the way for a more radical Big-Bang package to be executed from 1997.

Before turning to post-bubble financial reforms and early cases of pre Big-Bang FDI, it is instructive to examine to what extent a less regulated economy with more foreign competition can improve Japan's longer term outlook. David Weinstein demonstrates that Japan's economy has suffered structural problems as revealed through productivity figures relative to the U.S. Adding to a data set pieced together by Kuroda and Jorgenson in 1990, Weinstein shows that only Japanese manufacturing had converging tendencies with the U.S from 1960 to 1990 when FDI was almost entirely absent in Japan. (See Graph 2) Since they fail to find overall Total Factor Productivity (TFP) convergence in the entire economy, yet do see the trend in manufacturing, services must therefore be the lager-the area where FDI entered in the Big-Bang period. And writing with Robert Lawrence, Weinstein also finds that contrary to the conventional wisdom, not only did the exporting sectors not grow faster during this 30-year period, but there is no evidence that export sectors grew especially quickly. Instead, "higher levels of *import* intensity are associated with more rapid technological convergence." [35] Lawrence and Weinstein conclude that as the weaker sectors are liberalized, future productivity gains will result due to greater competition.[36] The imports do not necessarily have to come in the form of only products but as FDI, which can substitute for importation from the perspective of Japanese companies in these weaker industries. As will be shown, unlike past FDI into Japan, which was heavily concentrated in manufacturing, the new FDI has become more concentrated in once heavily protected Japanese industries including finance.

Graph 2 : Japanese Productivity Relative to the U.S., 1960-1994



(Source : David Weinstein, 2001)

Weinstein also exposes flaws in an OECD report which some researchers have used to claim structural reform would have little impact on future GDP growth. Weinstein concludes that if Japan could eliminate all structural problems and liberalize to a level seen across industries in the U.S., the GDP would rise by a full 33%.[37] Therefore, greater FDI flows into Japan would foster a competitive climate across all industries and raise productivity in the non-manufacturing sectors rather than by simply increasing capital or focusing on productivity gains in manufacturing, which has been accomplished as Japanese companies competed with firms in foreign markets.

Reforms During the Years of Political Fissures

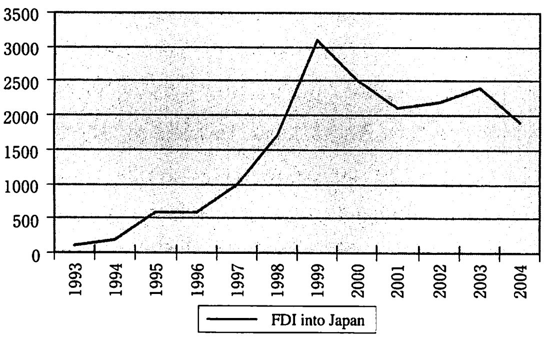
The level of FDI into Japan during the early 1990s between the bubble and the Big-Bang was consistently low until 1995 before picking up in 1996, reflecting both slow but steady deregulation in the period and an anticipation of the Big-Bang. Steven Vogel argues that prior to 1997, the Japanese government had embarked on enacting deregulation measures, yet at times it reverted to essentially "re-regulation." [38] While the criticism held true across certain industries prior to the Big-Bang reforms, important deregulatory change was unfolding in this pre Big-Bang period. One of the most important laws creating a more receptive environment for foreign investment through mergers and acquisitions (M&A) was the Security Transaction Law passed in 1990 where notification of a merger or takeover with a foreign company was no longer necessary. The Administrative Procedure Law passed in 1992 was a precursor to Big Bang reform and harmonized the reviewing of process standards, reducing arbitrariness in granting and renewing licensees. In addition, a new level of accounting transparency mandated by the central government importantly allowed public actors to gain much more information about specific bureaucratic procedures, thereby reducing inefficient information asymmetries, where one party has an unfair advantage.[39] This law also set a precedent for further transparency reforms in the banking system five years later.

Despite this post bubble reform, FDI into Japan remained low in the early 1990s due in part to a weak U.S. economy and a still heavily regulated Japanese economy. In 1993, the Financial System Reform Act went into effect, creating the first steps foreshadowing part of the Big Bang reform which would allow banks, brokerage houses and life insurance companies to compete in each others'traditional sectors, thus influencing these industries with much needed competition. Yet this 1993 reform came about due to a compromise inside MoF as it became a practical necessity given *other* heavy regulations still maintained in the banking sector.[40] The law was passed with little public interest as scandal and electoral reform grabbed media attention.

During the early 1990s, many companies within the *keiretsu* system had started to become saddled with post bubble debt burdens yet the strength of their connections had not yet begun to transform as during the late 1990s period when FDI began to increase several fold. In contrast to this temporary continuity from the pre bubble period, domestic politics changed dramatically as the Liberal Democratic Party (LDP) splintered due to a series of MoF related banking scandals and internal strife. As the Big-Bang laws were passing through the Diet, MoF's influence had steadily eroded from its heights prior to the bubble period, further loosening the ministry's grip on economic policy.

Prior to the opening shot of the Big-Bang in 1997, the paltry amount of FDI into Japan was less than 1/20 th the rate of FDI flowing into the U.S. (controlling for economic size),where a sizable percentage of FDI inflow into the U.S. was from Japanese companies. By 2001, however, the ratio was up sharply to 1 to 4 . The following year, investment levels over 1 to 2 as FDI entered Japan in a stronger economy and FDI into the U.S. had fallen sharply due to a stagnant post internet-bubble economy.Over the past five decades. the total stockpile of FDI into the U.S. has greatly exceeded that of Japan, but the Big-Bang period marked a break from Japan's past as an FDI outlier among OECD nations. Moreover, the largest gains in FDI into Japan have occurred during a global post-internet bubble slump in world wide cross-border investment flows.

Graph 3 : FDI Inflows, ¥ billions



(Source : Ministry of Finance, 2004 ; JETRO 2005 value for 2004 tentative)

Large-Scale Retail Store Law and Early FDI

Changes in the Large-Scale Retail Store Law opened the door to Western firms wishing to establish a presence in Japan. As previously discussed, this law began to weaken in 1990 partly due to internal political pressures along with some *gaiatsu* from the U.S., and in part against small business lobbying which has traditionally supported the LDP. As a result of less regulation, Toys 'R' Us has significantly expanded through out Japan in the past decade.[41] The previous law restricted location, size, business hours of large stores, and permission from MITI was required before an opening.[42] A series of modifications of the Large Store law between 1990 and 1994 opened up new possibilities for foreign companies wishing to gain a foothold in the large Japanese market prior to an even more liberal Big Bang revision in 2000 (changed to the Large-Scale Retail Store Location Law) through the big bang reform. Former restrictions favored established companies within a distribution *keiretsu* structure.

Other industries received FDI, including expansions by American and French auto makers, Ford Co. and Renault. Both stirred up the industry through first acquiring greater shares, thereby positioning themselves for subsequent cost-cutting restructuring during the anticipated Big-Bang years. In 1996, Ford raised its stake in Mazda from its initial modest investment in1979 to 33 percent just prior to Hishimoto's Big Bang announcement.[43] The company was also able to tap into the Mazda dealer system in order to expand sales in Japan once close to foreign firms. French Renault grabbed even greater media attention when it bought shares of Nissan in 1995, again positioning itself for creating a more significant impact on the auto industry in 1999.

As foreign companies' interests rose in Japan following the end of the bubble period, Japanese institutional bulwarks' influence began to decrease. MITI's role shifted away from industrial policy, emerging as the less influential METI in 2001. The Ministry of Finance (MoF) became entangled in bubble related scandals, becoming ripe for reform. Shinoda Tomohito notes that MoF's distorting influences on both politics and the economy were becoming disruptive in the 1990s : "Critics argued for years that MoF authority was too strong and that the ministry's use of its fiscal authority for the financial market distorted government policy, creating problems such as the jusen crisis." [44] Importantly, MoF's role as a supervisor of Japan's financial sectors was transferred to the Financial Supervisory Agency (FSA).[45] Big-Bang laws passed in 1998 rendered some of the ministry's powerful functions obsolete as a weakened

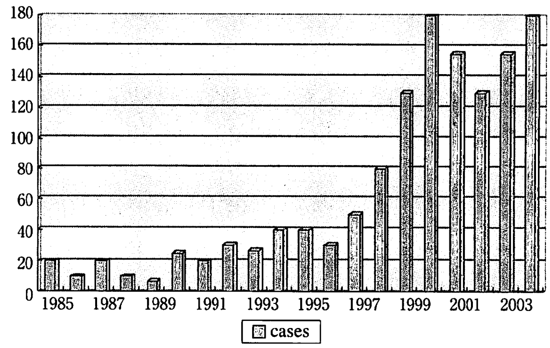
LDP continued to pass legislation which deregulated the economy similar to U.S. in the 1980s, thereby producing a more flexible and globalized financial system.

Foreign investors have also closely watched MoF oversight diminish as deregulation allowed banks, insurance companies and security firms to compete in each other's traditional service territories in a new open era. Prior to the Big-Bang, MoF officials were graduates from top law schools with insufficient knowledge of the increasingly complex world of finance, including specialized derivatives developed in the U.S. Over-The-Counter derivatives were considered gambling among Japanese bureaucrats, even though every other OECD member traded under a flexible system.[46] Until the new laws came into effect, MoF decided which industry would get to handle a new financial product and this affected all levels of investment: "MoF was forced to prioritize the issue of whether the banking industry or the securities industry would handle each new product at the expense of the investor protection issue." [47] Recent shifts in finance laws to an emerging global standard have made foreign investment more attractive to companies seeking familiar rules and a level playing field in Japan.

FDI Flows in Over The Lowered Dam

As the Big Bang laws lowered the FDI dam in 1998 and 1999, investment rushed into Japan at unprecedented levels. Throughout this early Big-Bang period, most foreign companies were seeking to expand their business to take advantage of specialization and so sought out joint ventures with Japanese firms. The inward FDI graph shows that foreign investment in terms of amount and cases more than doubled in this two-year period.

Graph 4 : M&A of Japanese Companies by Foreign Firms



(Source: Recof Corp.; reprinted from the Nikkei Shimbun)

Before turning to an examination of FDI into specific industries during this period, it is helpful to further consider the impact of a foreign firm with Japanese firm merger (an "out-in" merger) compared to the more numerous Japanese firm with Japanese firm "in-in" mergers. These Japanese M&As also sharply increased in this period to record levels in 2004[48], which will ultimately result in greater strengthening and flexibility on Japan's once "arthritic economy."[49] As Hoshi and Kashyap note, many so called in-in mergers among Japanese companies failed to deliver critical restructuring that foreign companies could more easily provide through creating a more unique blend of business practices, which in turn diffuse through Japanese industries if successful.[50]

A recent study by Kyoji Fukao highlights the importance of FDI on Japanese industries by comparing total factor productivity (TFP) gains in Japanese industries as a result of exclusively Japanese investment based in-in mergers with out-in mergers where FDI plays a direct role. The study, which measured effects of mergers in Japan from 1994 through 1998, controlled for the possibility that foreign companies may have simply invested in industries where TFP had been already increasing and factored this out. Fukao also dispels the notion that foreign "vulture" capital funds are seeking quick profits by taking advantage of troubled firms through technology transfers *from* the Japanese company to the foreign company[51] and concludes :

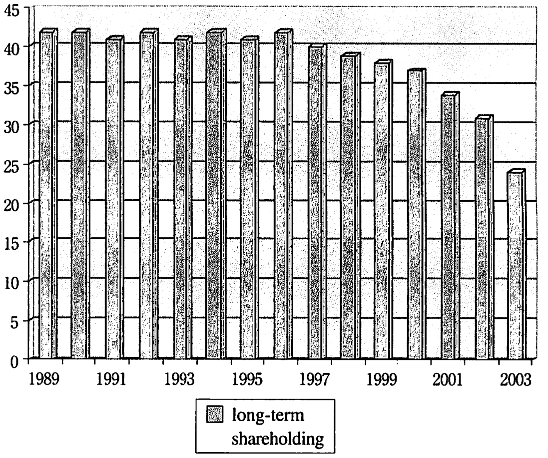
* foreign-owned companies have a 10% higher TFP and higher returns on capital. (Japanese companies, especially if within a keiretsu group, had access to easy money where incentives to produce a high rate of return were reduced by moral hazard.)
* foreign owned firms had a higher capital/labor ratio
* foreign owned firms had "higher R&D intensity"
* foreign firms offered higher wages[52]

Fukao's analysis provides strong evidence supporting the theory that foreign direct investment can have a strong positive effect on Japanese productivity where industries receive it. A longer term study would likely show that further TFP gains as the effects of FDI diffuse over time and encourage further investments in a positive cycle.

The Keiretsu Loosens During the Big Bang Phase

At the start of the Big Bang, *keiretsu* ties began to loosen, as evident in part by the reduction in long-term shareholding. Gary Saxonhouse's post-bubble analysis of *keiretsu* companies shows that *keiretsu* companies started to unravel slightly from 1990 due to the sell-off following the inflated stock market. More strikingly, J.P. Morgan data reveals that by one measurement, cross-holding shares accounted for 60% of Tokyo Stock Exchange capitalization in1995 and had dropped to 40% by 1999.[53] The following graph shows the decline in long-term shareholding from the late 1990s through the end of the Big Bang period[54] :

Graph 5 : Long-term Cross-shareholding



Sources : NLI Research Institute, reproduced from The Economist Mar 20, 2003 ; 2003 data, JETRO

American securities companies have been at the center of mergers and acquisitions deal-making, which are eroding the bonds within *keiretsu* groups. Japan's second and third largest steel companies NKK Co and Kawasaki Co. hired Goldman Sachs and Morgan Stanley, respectively, to negotiate their merger while Mitsui Chemicals and Sumitomo Chemicals used the same U.S. firms to create the fifth largest chemical company in the world.[55] Before 1998, Japanese firms would only use in-house negotiators to execute such mergers. The head of Japanese M&A for Goldman Sachs explained in 2001, "As foreign investment rises to new record levels, firms are increasingly sensitive to the impact that the boardroom decisions are having on their price share... these companies are more sensitive to the impact of capital markets." [56] Conversely, these Japanese firms are increasingly less beholden to the *keiretsu* group. Some core *keiretsu* relationships will survive, yet many ties will continue to loosen over time, thereby increasing market liquidity and importantly improving the efficiency of all Japanese industries.

GE Capital entered Japan's debt market in 1998 and the same year the Ripplewood Holdings investment group purchased the bankrupt Long Term

Credit Bank (LTCB) bank, thereby infusing the market with new practices from outside the previous domestic financial markets, dovetailing recent reforms as by a foreign investment group marked a watershed event in Japan's more open economy as the foreign entrants sifted through bad loans. LTCB was historically nationalized in autumn 1998, and at the same time, the government allowed Merrill Lynch to buy Yamaichi Securities. Ripplewood Holdings, was able to enter where a conglomerate of Japanese banks, already mired in bad loans, refused to tread.[57] This process placed necessary constraints on companies in red ink and also demonstrated that a foreign run bank could be both profitable and a positive longer term influence.

A year later, French automaker Renault's increased stake in troubled Nissan made just as visible an impact on the auto industry and altered parts of the *keiretsu* system. The foreign automaker began buying shares of Nissan in 1995, but significantly increased its stake of Nissan to 33% and placed notorious cost-cutter Carlos Ghosn at the helm the struggling automaker. After rapid changes, the company quickly rebounded. Nissan cut 15% of its workers from 1999 to 2000[58], although Fukao's analysis reveals that until 1998, foreign investment had not resulted in job cutting at a rate any higher than Japanese owned companies.[59] More strikingly, Nissan, which had been a MITI favorite in the 1980s, shed almost half of its 1145 suppliers leaving 600 after restructuring while only four share holding companies remain from nearly 1400 prior to Renault's involvement.[60] With the media focus on both deregulation and the jump in FDI in the late 1990s, Ghosn became one of the most widely quoted CEOs in the country, and Japanese management teams studied the success story as many of their companies floated in a sea of red ink.[61] In addition to labor cuts and a substantially reduced network of suppliers, far fewer shareholding companies are invested in Nissan as only four remain out of over 1300.[62] Nissan's loosening from the *keiretsu* structure was just one part of a broader trend and DaimlerChrysler's purchase of a stake in Mitsubishi Motors in 2000 leaves only Toyota and Honda without a foreign partner in Japan's automobile sector.

Keiretsu ties have been weakening for over a decade, which based on previous studies cited, should somewhat increase the profitability of Japanese companies and more significantly open the economy up to both domestic and foreign mergers as the economy becomes more flexible. The mega-merger of Fuji Bank, Industrial Bank of Japan and Dai-Ichi Kangyo into Mizuho represented a shift towards more transparent market practices : Even more notable than the size of the deal was the "astonishment over the willingness to abandon traditional keiretsu ties." [63]

Broader globalization trends are also exerting pressure on *keiretsu* connections as manufacturing companies continue to expand into China as ties with distributors weaken as cheaper suppliers are found. FDI has also started to flow in from China where several companies have bought Japanese firms in recent years. The amount of FDI from China is certain to increase as Japan continues to deregulate, Chinese companies strengthen and increasingly powerful IT further reduces the distance between the two countries.

FDI After Takenaka in 2003

After Takenaka's appointment to the FSA in late 2002, FDI flows into Japan began to return to match the 1999 record level. METI, now a leading advocate for increased FDI into Japan, partially credits an improved business climate for the 50% increase in FDI into Japan in 2003, which it state was spurred on in part by further deregulation and structural reforms.[64] But longtime Tokyo investor Jack Rodman emphasizes Takenaka's appointment and asserts, "After Takenaka came in and took the bull by the horns, it opened up a wave of transactions." [65] It is difficult to ascertain to what extent Takenaka's actions have affected FDI flow into Japan, although a reformed and now sound banking system will attract more FDI, ceretis paribus.

The largest foreign investment deal of 2003 once again placed Ripplewood Holdings in the spotlight. The $2 billion dollar leveraged buyout of Vodafone's Japan Telecom fixed-line business involved a different political dynamic from the investor group's previous buyout of LTCB. Since a British company already owned Japan Telecom, political resistance to the deal was low. Edward Lincoln noted shortly after the deal became public that, "Since this represents a sale by one foreign owner to another foreign owner, this represents a zero increase in foreign direct investment in Japan. And if it is a transaction between two foreign owners, it does not represent a change in Japanese behavior." [66] However, this analysis discounts the ability for foreign transactions to affect *all* types of mergers in Japan in the longer run.

Brokerage analysts list several reasons why the deal set a precedent in M&A bids and how acquisition affected the operations in telecommunications industry. First, the purchase forced NTT to face a tougher competitor on the formerly monopolized turf. Ripplewood also accumulated the requisite capital from Japan's four largest banks, thereby spreading the risk as well as involving a maximum number of key domestic players to gain information from the deal helping to diversify risk and deflect political criticism.[67] Such a joint-venture would not have been conceivable prior to the Big Bang. An increasing acceptance of foreign based M&As is also important for the long-term prospects of Ripplewood and other new entrants. Finally, corporate finance director, Kentaro Nakamachi, depicts the broader picture of such a major transaction : "It will be a landmark for the mergers and acquisitions market in Japan, giving participants confidence that leveraged buyouts will also work here...More companies may be encouraged to sell their large sized-subsidiaries." [68] M&As within Japan have maintained historically high levels, and new laws on the docket to be analyzed in a later section will perpetuate the trend.

Wal-Mart and the Distribution Keiretsu

American and French retail giants Wal-Mart and Carefour entered the Japanese market after the Big Bang and are influencing the way stores are managed by streamlining distribution systems and providing more options for the consumer. Wal-Mart bought a 6 % stake in Seiyu in 2002 and increased to 37% later in the year with rights to acquire a full 67% share in 2007. Seiyu managers accustomed to insulation from heavy competition have resisted the notorious, cost cutting practices of the foreign buyer.[69] But over one-third of Seibu stores now use Wal-Mart's inventory tracking system, thereby bolstering the company's profitability. In response to Wal-Mart's competitive threat, the foreign giant has inspired Ito-Yokado and Aeon, the number one and number three largest retailers to open a large complex together.[70] And both foreign and domestic competitors now scout each other's stores in all three countries to seek out consumer preferences.[71] Aeon President Motoya Okada describes a "Wimbledon effect" in the retail industry as a race "between how much time we will need to become competitive and how much time global retailers will need to understand Japanese consumers and the market." [72] Ultimately, as in the case of the UK after deregulation in the 1980s, Japanese firms will have a long-term advantage operating on the home court.

Wal-Mart's entry also weakens the *keiretsu* bonds in the retail sector. Due to previously discussed changes in the Large Scale Retail Store Law, several layers of redundant distribution layers disappeared from the early 1990s to the Big Bang in 1997. In addition, sales between wholesalers dropped 40% during this short period leading up to the Big Bang.[73] Staff traditionally rotated between the wholesale and retail level which provided some stability, but this also served as an indirect barrier to foreign competitors trying to attract labor.[74] Wal-Mart has entered Japan without the type of U.S. pressure that had helped establish Toys R Us over a decade earlier. As with the toy company, Wal-Mart's presence serves as a catalyst for changes within an already transforming Japan. In addition to competitors studying Wal-Mart's practices, Aeon eliminated several wholesalers in its distribution system and started ordering directly from manufactures, thereby mimicking Wal-Mart's methods. Two early contributors have been Japanese subsidiaries of Western companies, Unilever of the Netherlands and Proctor and Gamble of the U.S.[75] Over 40 companies now more efficiently supply Aeon in the same manner that Wal-Mart is supplied.[76]

As the banking industry became the focus of Japan's long recession, Mizuho Bank, the largest bank, quickly tested not only the new government policy the strength of *keiretsu* loyalty. It announced that its debt had swelled in the recession and that its losses were nine times greater than previously stated in January of 2003.[77] This required Mizuho to quickly raise capital, so the bank called on Merrill Lynch to try to sell part of the retail side located in Hong Kong to Industrial Commercial Bank of China.[78] Hiroshi Okumura, author of *Corporate Capitalism in Japan*, argues that Mizuho's recent capital-raising strategy indicates that *keiretsu* ties are weakening. By turning to 3,400 firms to raise capital, Mizuho exposed its weaknesses and revealed that its core *keiretsu* ties from pre-merger banks (Fuji Bank, Daiichi Kangyo Bank, and the Industrial Bank of Japan) were no longer sufficient to provide funding as they would have before the Big Bang. For example, Carlos Ghosn, President of Nissan Motors, a former Fuyo group member, declined to assist by buying shares in the bank.[79]

The Revised Corporate Law: Triangle Mergers, Poison Pills and the Next Wave of FDI

Starting from very low levels in the immediate post bubble period, FDI will continue to play an important role in Japan's evolution towards a more globalized and productive nation. Ripplewood Holdings, Renault and others have already influenced the political economy but a seemingly archaic revision in the Corporate Law (planned for execution this year but delayed due to the unfolding Livedoor scandal) will lower barriers even further, thereby facilitating a potential flood of new mergers and acquisitions between domestic and foreign companies. Despite Hashimoto's Big Bang slogan, "free, fair and global," declared at the end of 1996, the set of Big Bang laws were not composed with international stock swaps in mind; therefore, an extra barrier on domestic and foreign firms wishing to merge in Japan was left in place. Under current law, a foreign firm's Japanese subsidiary seeking to acquire a domestic firm in a so-called "triangle merger" must use its own shares as compensation to the shareholders of the acquired company. Legislation drafted in 2005 will loosen this restriction, allowing international share swaps which. This change permits a foreign firm to establish a wholly owned subsidiary in Japan to acquire a Japanese company using the foreign parent's shares as payment.[80]

The Diet will likely pass the corporate law legislation next year, and the government and the LDP will debate the tax code to ensure that it meshes with the "triangle merger." [81] A senior MoF official suggests that the disincentives for foreign mergers will be removed by 2006: "In concert with the revised Commercial Code, we plan to include measures in the revised fiscal 2006 tax code to be set at the end of next year." [82] Once these steps are taken, M&A incentives will be more uniform across Japan, the U.S. and the EU. Foreign-domestic mergers have risen in the post Big bang economy, but this number will likely increase sharply as the result of the new revisions.

Another mainstay of American capitalism, the hedge fund, is being created to target just Japanese companies at a rate of one per week by American investors but also by Japanese entrepreneurs like Makoto Kikuchi. Foreigners put up the majority of the capital, yet wealthy Japanese individuals may contribute over 25 percent in some funds.[83] Often vilified in the Japanese media, hedge funds can serve a positive role by absorbing risk in the stock market. The revised Commercial Code will further fuel the growth of these funds, although the overwhelming majority of FDI into Japan will enter through established firms.

A late 2004 survey showed that CEOs of major corporations are also wary of the proposed legal changes to create easier access for foreign firms wishing to enter or expand into Japan. According to a recent *Nihon Keizai Shimbun* survey in the fall of 2004, nearly 70% of CEOs consider takeovers by overseas firms via the proposed stock swap option to be a threat.[84] Yet at the same time, another survey conducted by the same newspaper found that 90% of presidents of major Japanese companies say that they are willing to use mergers and acquisitions in order to improve their competitiveness. About half were also willing to use investment funds.[85] Prior to the Big Bang, it is likely that 90% of the CEOs would *not* have considered such an option. Keidanren's statement and polls of CEOs reveals that Japanese managers understand the need to allow a greater foreign presence but remain ambivalent.

Japanese security firms have been preparing for heavier volume in the next few years. An M&A broker at Nomura Co. noted, "New foreign advisors who worried about reputations if they handled a hostile client say they are now willing to help make the bids." The firm has responded to the recent change in attitude and started distributing a pamphlet on defense strategies against hostile takeovers after receiving so many inquiries.[86] Nobuo Sayama, a noted M&A adviser, says he is also flooded with inquiries from foreign concerns planning corporate takeovers in Japan.[87]

Major Japanese firms are also preparing for the potential flood of FDI into Japan. For example, leading automaker Toyota Co. held an executive meeting where strategies to block its subsidiaries from take over were at the top of the agenda. Its *keiretsu* structure could be severely damaged if a major shareholder entered through a "triangle takeover." Toyota has begun studying measures to cope with the possibility of either a foreign or possibly domestic intruder by considering defensive strategies by securities houses.[88] Notorious American investor T. Boone Pickens attempted to buy a Toyota parts subsidiary 15 years ago but was defeated as the Toyota group firms blocked the bid. Even a highly successful vertical *keiretsu* like Toyota will be more vulnerable from 2007. Bandai's President questions if such strategies can help his company. When U.S. toymaker Mattel Inc. considered buying Bandai with its own shares once the new laws go through, Bandai President Takeo Takasu summed up the sentiment of other concerned CEOs by conceding that, "It's no use struggling." [89]

Many companies will only see an increase in foreign stakes which are not intended for takeover purposes. The president of Myojo Foods Co, an instant noodle maker, says that he was stunned to learn that the American investment group Steel Partners Japan had become the company's largest shareholder. But the CEO adds that he changed his view while having talks with Steel Partners Japan executives. "I've never been more conscious of the existence of our shareholders. My management has not been rigorous enough." [90] The noodle company is in the middle of a major restructuring, including distribution operations. Spurred on by Steel Partner Japan's 14% stake, Mr. Nagano explains the new significance of the shareholder: "I intend to improve our management efficiency so that we can gain the trust of shareholders, whoever they are." [91] In contrast to the pre Big Bang period, *gaiatsu* is coming directly to companies and sometimes through the backdoor.

Conclusion

Foreign direct investment (FDI) into Japan, once scarce from the end of World War II to the end of the Cold War, has increased steadily from the bubble period in the late 1980s and more dramatically from the start of Big Bang reforms in the late 1990s. Higher levels of FDI have transformed Japan's political economy into one that is "flatter" and significantly more globalized. New laws that are likely to go into effect in 2007 will further lower barriers to foreign direct investment, and undoubtedly attract more foreign companies to more industries thereby further influencing Japan's political economy as it converges closer to those of the U.S. and U.K. Differences will remain, but the shrinkage by 2009 compared with the end of the bubble in 1989 will be striking.

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